PUBLIC SERVICE COMMISSION OF WISCONSIN

Memorandum

November 20, 2006

TO: The Commission

FROM: Robert Norcross, Administrator
Donna Holznecht, Assistant Administrator
Mary Kettle, Auditor/Docket Coordinator
Gas and Energy Division

RE: Application of Madison Gas and Electric Company for Authority to Change Electric and Natural Gas Rates — 3270-UR-114

BRIEFING MEMORANDUM

STATEMENT OF THE PROCEEDING

This is a Class 1 contested case to consider Madison Gas and Electric Company's (MGE) request to reopen docket 3270-UR-114 to update certain costs and establish new electric rates for 2007. The Final Decision in the base case of this docket established rates for service beginning January 1, 2006. It authorized MGE to submit an update of its forecast for the 2007 calendar year electric fuel costs to be monitored under the fuel rules for Commission review and approval. It also authorized MGE to provide an updated estimate of the 2007 carrying costs related to its investment in the Elm Road Generating Station (ERGS) with its update of electric fuel costs for 2007.

In its application requesting to reopen this docket, MGE requests an electric rate increase of $4,256,000[1] to update its forecast of electric fuel costs for 2007 and the estimate of 2007 carrying costs related to its investment in ERGS. The company further requests to extend the

[1] This is the amount of increase based on rates in effect after the stipulated fuel credit authorized in the Commission's May 25, 2006, Order in docket 3270-FR-100.

escrow accounting treatment for American Transmission Company LLC (ATC) related transmission costs through December 31, 2007. (Johnson, Tr. 343) In addition, MGE submitted supplemental testimony that it had signed an agreement to purchase the wind turbines, the land, and related infrastructure required for its proposed wind project to be completed in 2007. MGE is requesting Commission approval to record 100 percent allowance for funds used during construction (AFUDC) on this project. (Johnson, Tr. 346-347) Finally, at the hearing in this proceeding, MGE requested recovery in 2007 of the 2007 level of ATC network service fees. This change to the company's application increases MGE's requested electric rate increase to $6,325,000 and this amount is subject to changes in the NYMEX strip.

On September 6, 2006, a prehearing conference was held to determine the issues to be addressed in this docket and to establish a schedule for the hearing. On October 30, 2006, a technical hearing was held in Madison before Administrative Law Judge Edward S. Marion. No separate public hearings were held. Simultaneous briefs and reply briefs were filed with the Commission on November 10, 2006, and November 16, 2006, respectively.

This briefing memorandum provides background and discussion of each party's position on contested issues, based on the record in this proceeding as well as briefs filed by parties. This memorandum also presents alternatives for each contested issue, including a discussion of each alternative.

REVENUE REQUIREMENT AND RATE DESIGN

1. Should MGE's rates be increased to recover additional costs related to its investment in ERGS? (Uncontested)

2. Fuel Costs

a. What level of monitored fuel costs should be included in 2007 revenue requirements? (Uncontested)

b. What monitoring ranges should be used to monitor 2007 fuel costs?

Background

Prior to the 2006 test year, MGE was monitored under symmetrical fuel ranges as follows: 1) an annual range of plus or minus 3 percent; 2) a monthly range of plus or minus 10 percent; and 3) a cumulative range of plus or minus 10 percent for the first month of the test year, plus or minus 6 percent for the second month of the test year, and plus or minus 3 percent for the remaining months of the test year. In light of the record high natural gas futures prices that were used in the 2006 forecast of monitored fuel costs, asymmetrical fuel monitoring ranges were established to reflect the fact that it was likely that actual natural gas prices would be lower than the futures prices.

Discussion

In light of a return to more representative natural gas prices, Commission staff proposed returning to the symmetrical fuel monitoring ranges authorized by the Commission prior to its decision in the 2006 test year rate case. In that decision, asymmetrical fuel monitoring ranges were established to reflect the fact that it was likely that actual test year natural gas prices would be lower than the natural gas futures prices used in forecasting 2006 monitored fuel costs, which were at an all-time high. The monitoring ranges proposed by Commission staff were as follows:

1) an annual range of plus or minus 3 percent; 2) a monthly range of plus or minus 10 percent; and 3) a cumulative range of plus or minus 10 percent for the first month of the test year, plus or minus 6 percent for the second month of the test year, and plus or minus 3 percent for the remaining months of the test year. (Hillebrand, Tr. 379-380)

MGE also proposed returning to symmetrical monitoring ranges, but with tighter tolerances. MGE's proposal was to monitor 2007 fuel costs as follows: 1) an annual range of plus or minus 2 percent; 2) a monthly range of plus or minus 8 percent; and 3) a cumulative range of plus or minus 8 percent for the first month of the test year, plus or minus 5 percent for the second month of the test year, and plus or minus 2 percent for the remaining months of the test year. These are the ranges that were used to monitor MGE's fuel costs for 2006 under the stipulated agreement, with the Citizens' Utility Board (CUB), Wisconsin Industrial Energy Group, and the other parties, under which MGE agreed to implement a fuel credit and return any overcollections of 2006 fuel costs collected on or after Match 9, 2006. MGE also states that these tighter tolerances will reduce risks for both shareholders and ratepayers in the event of dramatic changes to the natural gas prices used in the test year fuel forecast, that no one opposed these ranges in this docket, and that these ranges are consistent with the ranges other Wisconsin utilities' fuel costs are monitored under. (Johnson, Tr. 349-350, MGE, Br. p. 4)

In light of the lack of opposition by any of the parties to MGE's proposed fuel monitoring ranges, and the fact that three other Wisconsin utilities are already monitored under these proposed ranges, Commission staff considers MGE's proposed fuel monitoring ranges to be reasonable.

Alternatives

Alternative One: The Commission could establish fuel monitoring ranges as follows: 1) an annual range of plus or minus 2 percent; 2) a monthly range of plus or minus 8 percent; and 3) a cumulative range of plus or minus 8 percent for the first month of the test year, plus or minus 5 percent for the second month of the test year, and plus or minus 2 percent for the remaining months of the test year.

Alternative Two: The Commission could establish fuel monitoring ranges as follows: 1) an annual range of plus or minus 3 percent; 2) a monthly range of plus or minus 10 percent; and 3) a cumulative range of plus or minus 10 percent for the first month of the test year, plus or minus 6 percent for the second month of the test year, and plus or minus 3 percent for the remaining months of the test year.

Alternative Three: The Commission could continue the asymmetrical fuel monitoring ranges authorized in its December 12, 2005, Final Decision which are as follows: 1) for the annual range, plus 2 percent or minus 0.5 percent; 2) for the monthly range, plus 8 percent or minus 2 percent; and 3) for the cumulative range, plus 8 percent or minus 2 percent for the first month of the year, plus 5 percent or minus 1.25 percent for the second month of the year, and plus 2 percent or minus 0.5 percent for the remaining months of the year.

3. What is the appropriate rate treatment in 2007 for ATC-related transmission costs?

Background

In the base case proceeding in this docket for the 2006 test year, MGE requested approval to continue escrow accounting through December 31, 2007, for ATC-related transmission costs that are currently being escrowed and requested a step increase for this item for 2007. The Commission's December 12, 2005, Final Decision in the base case of this docket authorized

MGE to continue escrow accounting only until December 31, 2006, and indicated that a step increase for 2007 is not appropriate. The Final Decision also indicated that, if the 2007 ATC-related transmission costs were projected to be significantly higher than the amount included in the base case of this docket, the company may request deferral accounting treatment for the incremental amount. (Kettle, Tr. 369-370)

In this proceeding, MGE is requesting to extend the escrow accounting treatment for ATC-related transmission costs through December 31, 2007. At the hearing, MGE discussed the options available to the Commission with respect to this issue. It stated that the Commission could incorporate the projected increase in the ATC-related costs in 2007 into the rate change for 2007 because the change is known and significant. MGE stated that, alternatively, the Commission could allow the company to continue the escrow for these costs through December 31, 2007. Finally, MGE stated that the Commission could allow the company to defer the incremental cost in 2007. The company further stated that, if the Commission determined that continuation of the escrow for these ATC-related costs is not appropriate, MGE would prefer a step increase for the incremental amount over deferral of it. (Johnson, Tr. 339-340)

In its initial brief, MGE indicated that it is willing to accept a modified approach proposed by Commission staff in the pending cases for Wisconsin Public Service Corporation (WPSC) and Wisconsin Power and Light Company (WP&L). Under this approach, the escrow would end on December 31, 2006. MGE would be allowed to recover in 2007 the incremental costs associated with the ATC-related transmission costs currently being escrowed. Any downward adjustments, or refunds, in network service fees during 2007 would be deferred until they could be returned to ratepayers. (MGE, Br. p. 6)

Discussion

Since the Commission's December 12, 2005, Final Decision in the base case of this docket was issued, circumstances have changed such that the Commission may wish to reconsider its previous decisions for 2007 with respect to this item. The subject of whether to continue escrow accounting for these costs is an issue in the pending WP&L rate case as well as in the pending WPSC rate case. In both of those cases, Commission staff presented two alternatives for Commission consideration. Under one alternative, escrow accounting treatment would continue for only the network service fees, which is one component of ATC-related transmission costs currently being escrowed. (Johnson, Tr. 341) Under another alternative proposed in those cases, escrow accounting would end, but the updated network service fees would be included in revenue requirement and any refunds received would be deferred until they could be returned to ratepayers. (MGE, Br. p. 6) To the extent the Commission wishes to be consistent among the utilities with respect to this issue, these alternatives may be reasonable for the network service fee component for MGE.

While consistency is one factor to consider, there are also reasons why the Commission may consider it not appropriate to be consistent with its decisions in the WPSC and WP&L rate cases with respect to this issue. The WPSC and WP&L rate cases were full rate cases and all of the companies' estimated revenues and costs were audited by Commission staff. This proceeding is a limited issue reopener, and Commission staff has not audited all of MGE's estimated costs and revenues for 2007. In addition, a step increase was determined not to be appropriate in 2007 for this issue so MGE's request for rate recovery in 2007 for ATC/Midwest Independent Transmission System Operator (MISO) costs currently being escrowed could be considered to be beyond the scope of this proceeding.

Alternatively, since the 2007 level of network service fees is known at this time, it may be reasonable to allow the company to recover these costs now rather than continuing to defer a known amount, especially considering that MGE's investment in ERGS will result in significant upward rate pressure in future years. (Johnson, Tr. 340-341; Kettle, Tr. 369) Current recovery of this component of ATC/MISO costs currently being escrowed would increase electric rates by $1,969,000.

The Commission has not yet decided either the WPSC or WP&L rate cases as of the writing of this briefing memorandum. Therefore, it is impossible to say which alternative is consistent with those decisions at this time. However, the alternatives that have significant support in those cases are:

1. Continue escrow accounting, but only for ATC network service fees (the majority of the total cost). For MGE, the costs no longer escrowed would be recovered in 2007 at the 2006 level.
2. End escrow accounting December 31, 2006. Allow recovery of updated 2007 costs recently issued by ATC and defer any downward adjustments or refunds until they can be returned to ratepayers.
   - Under this alternative, revenue requirement increases by $1,969,000 for ATC network service fees.

The record in this case includes other alternatives as well. The Commission could:

3. Continue the escrow accounting in its entirety that would otherwise expire December 31, 2006.
4. Follow the December 12, 2005 Final Decision which ends the escrow accounting on December 31, 2006 and doesn't provide any mechanism for rate relief for incremental costs above those authorized in the base case; except that MGE could apply for a deferral if actual costs are significantly higher than the amount included in the 2006 test year. In this case, MGE is requesting such deferral accounting, but only if the Commission doesn't either a) extend escrow account, or b: update the 2007 revenue requirement to reflect the higher costs. MGE testified that these costs are known and deferrals are generally authorized when costs cannot be estimated or when significant unforeseen costs occur within a test year. (Johnson, Tr. 340-341) Commission staff generally concurs with MGE's assessment of proper use of deferral accounting.

Alternatives

The alternatives listed are numbered consistently with the numbering in the discussion section.

Alternative One: Continue escrow accounting but only for ATC network service fees. Provide recovery of the incremental amount of network service fees in 2007 rates.

Alternative Two: End escrow accounting. Include the recently updated 2007 level of network service fees in revenue requirement and defer any downward adjustments or refunds.

Alternative Three: Continue escrow accounting in its entirety as previously authorized through December 31, 2006, with no current recovery of incremental costs.

Alternative Four: End escrow accounting, and (allow/do not allow) deferral of incremental costs for 2007.

4. **Should MGE's request to record 100 percent AFUDC in 2007 on construction work in progress associated with its proposed wind project, as long as the construction expenditures as well as any associated AFUDC are at risk for rate recovery pending Commission approval of the construction authorization for the wind project? (Uncontested)**

5. **What is the appropriate revenue allocation to the customer classes?**

Background

MGE allocated its forecasted increase associated with the carrying cost for the ERGS using non-coincident class demands. MGE allocated its forecasted reduction in the cost of fuel based on energy sales. (James, Tr. 354-362; Ex. 43)

MGE Revenue Allocation			
Overall Increase	Residential, Lighting & Miscellaneous	Small Commercial & Industrial	Large Commercial & Industrial
1.34%	1.73%	1.34%	0.96%

MGE's proposed revenue allocation produces higher than the overall average increases for the residential, lighting and miscellaneous customer classes; approximately average increases for the small commercial and industrial customer classes and lower than average increases for large commercial and industrial customer classes.

Commission staff's revenue allocation of the ERGS cost used a 60/40 mix of demand and energy allocators, which the Commission staff has used in some rate cases to allocate production related costs. Coincident peak demand was used as the demand portion the ERGS cost allocation. Commission staff used energy or kilowatt-hour (kWh) sales to allocate both the energy portion of the ERGS cost and the fuel related costs in this reopener.

Commission Staff Revenue Allocation			
Overall Decrease	**Small Use**	**Commercial & Industrial**	**Contract Services**
1.03%	**0.80%**	**1.10%**	**1.44%**

The impact of the Commission staff revenue allocation is lower than average decreases for the small-use customer classes, approximately average decreases for commercial and industrial customer classes and higher than average decreases for the contract services customer classes. (Albrecht, Tr. 381-387, Ex. 50)

Discussion

The parties generally agree that the fuel costs should be allocated using an energy or kWh sales allocator. However, there is disagreement over the allocation of ERGS cost. CUB was given intervenor compensation to address this specific issue, which it did through cross-examination and brief. Both CUB and Commission staff agree that the use of a mix of demand and energy allocators is appropriate for spreading the ERGS cost to the customer classes. CUB cites a prior Commission order in a WEPCO rate case, docket 05-UR-102, in which the Commission decided it was “reasonable to allocate 60 percent of plant-related costs using a demand allocator and 40 percent of plant-related costs using an energy allocator.”

MGE witness Steve James stated that he used non-coincident demands because it provides the best estimate of the demands for the non-demand billed rate classes. Under cross examination Mr. James admitted that his proposed allocation of the ERGS cost is not described in the NARUC Electric Utility Cost Allocation Manual of January 1992 for allocating production costs. Commission staff witness Jerry Albrecht stated that coincident peak demand is generally used to allocate production related costs. (Tr. 356, 361-362; 385; CUB, Br. pp. 1-3)

The revenue allocation associated with the recovery of ATC/MISO costs through increased rates was not explicitly discussed in the record by the rate witnesses for MGE and Commission staff. The Commission could choose to reflect any ATC/MISO costs as part of the final costs that are recovered based on either revenue allocation proposal. Otherwise the Commission could pick a specific allocator to spread any ATC/MISO costs to the appropriate customer classes.

Alternative One: Determine that the revenue allocation proposed by Commission staff in Exhibit 50, adjusted for the final costs, is reasonable.

Alternative Two: Determine that the revenue allocation proposed by MGE in Exhibit 43, adjusted for the final costs, is reasonable.

Alternative Three: Determine either Alternative One or Two is appropriate, but identify a specific allocator to use for the ATC/MISO costs.

6. What is the appropriate rate design?

MGE proposed rate design includes changes in both energy and demand charges. For the energy-only classes MGE combines its allocation of the ERGS cost increase and smaller fuel cost reduction into a uniform increase of $0.00233 per kWh. For the demand metered classes MGE proposed a uniform increase of $0.01372 per kW per day for the demand charges and a decrease of $0.00015 per kWh for the energy charges. (James, Tr. 354-362; Ex. 43; MGE, Br. pp. 8-10)

Commission staff's overall decrease is 1.03 percent. Commission staff's analysis shows the majority of the costs behind this rate change are energy related. Given these circumstances the Commission staff proposed a slight reduction in energy charges for all classes, rather than a change in both energy and demand charges. (Albrecht, Tr. 381-387)

Alternative One: Determine that the rate design proposed by Commission staff in Exhibit 50, adjusted for the final costs, is reasonable.

Alternative Two: Determine that the rate design proposed by MGE in Exhibit 43, adjusted for the final costs, is reasonable.

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